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UNCLAS SECTION 01 OF 04 BRASILIA 002407

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PLS PASS FED BOARD OF GOVERNORS FOR ROBATAILLE

E.O. 12958: N/A
TAGS: EFIN ECON EINV BR
SUBJECT: PENSION REFORM: GOB VEERS, TACKS, TAKES ON WATER

Refs: A) Brasilia 1466, B) Brasilia 80

SUMMARY

¶1. (U) Lula's crucial pension-reform bill was approved by the Chamber of Deputies special committee on July 23 -- but only after undergoing political buffets and a perhaps fateful overhaul. In a fundamental about-face, the GoB has accepted that all current public-sector employees will remain eligible for pensions equal to their top salary (albeit with big improvements in minimum-age and time-worked eligibility criteria.) Chief factor behind this concession was shameless lobbying by Brazil's judiciary, which enjoys unique pension benefits and will ultimately decide any reform's constitutionality. There was also pressure from the GoB's base in Congress with its long ties to public-sector unions.

¶2. (U) Fiscally, the GoB claims the overall impact of its shift is negligible. Federal savings over the next twenty years will still total 50.7 billion, vs. 52.4 billion under the GoB's original proposals, supposedly. `The market' seems to take these numbers at face value, and has been placid. Politically, however, these early pension-bill concessions have seemed to pose doubts over the goals and resolve of Lula's team. They may have opened the door to a snowball of public clamor, brinkmanship, and further changes that will gut the reform. Lula's tax-reform bill, due for a committee vote soon, could get trapped in a similar cycle. He and his team undoubtedly sense the danger and now are drumming the message that they have gone to the limit of their pension-reform horse-trading. END SUMMARY.

A Fortnight's Commotion in Review

¶3. (SBU) The GoB's about-face began on July 9, following drawn-out dialogue with new Supreme Court Chief Justice Correa. The latter evidently sees his job as embracing the duty to lobby for retention of the judiciary's uniquely generous pension privileges, of which "integral" (100% of final salary) pensions are the capstone. The GoB in turn has to bear in mind that the Supreme Court can torpedo any pension reform by ruling it unconstitutional, as happened with Cardoso's 1998 proposal to tax pensions. Correa, Social-Security Minister Berzoini, and lower-House Speaker Cunha, with Planalto's Dirceu in the wings, conferred secretively for two weeks. Outcome: while Lula was in Europe, on July 10 local press headlined the administration's alleged surrender on the principle of "integral" pensions, not just for the judiciary but for the whole current public sector. Whether future public-sector workers, too, would get integral pensions was not made explicit.

¶4. (U) The news triggered consternation from media, Brazil's governors, and Finance Minister Palocci. Former Social-Security Minister Brant, who now heads the Chamber of Deputies' special committee on the subject, was widely quoted as saying "the new reform is no reform." Various PT politicians in and out of Congress lamented having stuck their necks out defending the GoB's original reform plan. Palocci by all accounts had not been kept current on the Cunha/Berzoini/Correa/Dirceu talks and wanted to cancel his European trip to join Lula, in favor of staying home to fight for the GoB's original reform guidelines.

¶5. (U) But the weightiest adverse reaction was from Brazil's governors. Fiscal pressure on their own state budgets from the pension system is as acute as on the Union's; many can afford to pay "integral" pensions even less. Lula made a point of forming and presenting his pension and tax reform plans to Congress with the governors' consensus in April. That the GoB now appeared to have negotiated so great a change in the pension-reform plan, leaving governors to learn about it in the papers, sat very badly. Key Minas Gerais and Sao Paulo governors Neves and Alckmin voiced opposition in careful but ominous tones. Temporizing, Dirceu convened a meeting July 16 with five representative governors, plus Cunha and Berzoini. At that meeting, Berzoini gave figures purporting that the changes overall would be revenue-neutral for states as well as the Federal Treasury. Governors seem to have warily gone along, but with the insistence that

future public workers be ineligible for "integral" pensions.

Lula Decides

¶6. (U) Meanwhile, from Portugal, Lula asserted his authority to arbitrate. At the tense inter-ministerial meeting which followed his return on Thursday July 17, according to an account in last week's "Epoca" financial weekly, Lula censured Berzoini and Cunha (but absolved Dirceu) for undue "precipitousness" in their political negotiations. Yet at meeting's end, despite Palocci's and Communications advisor Gushiken's arguments against, Lula gave his imprimatur to Berzoini's advocacy of integral pensions. Lula also endorsed the continuation of "parity," i.e., that retirees' pensions increase by the same factor as current workers' salaries. However, he ruled out letting future public-sector workers be eligible for integral pensions, and he reasserted the GoB's tough original guidelines in some other key respects.

¶7. (U) The next day, the bill's sponsor, Deputy Carlos Pimental (PT-Ceara) presented its adjusted version. Salient features include the following.

-- minimum conditions for integral pensions: (women) 55 years old with 30 years of INSS contributions and 20 years in the public sector, including 10 in present occupation ("cargo"); (men) 60/35/20/10 years, respectively.

-- for future public-sector employees, a monthly pension cap of BRL 2,400, with the option of a complementary pension fund contributed to by government (same as the initial GoB proposal).

-- pensions to be taxed at 11%, starting at the present personal-income tax floor of 1,058 Reals/month. The earlier agreement had been for a floor of 2,400/month.

-- salary and hence pension sub-ceilings for state and municipal judiciary employees of 75% the salaries of Supreme Court judges. The Berzoini/Cunha agreement had been 90.25%.

-- survivor's benefit (currently 100% of the pension without limit) to remain 100% only up to 1,058 Reals/month, with a 30% discount on anything above that level.

-- "parity" (cf. above) to be preserved for existing pensions of current and currently-eligible pensioners, and for other current public sector, but with definition of parity for the latter category left to a future complementary law.

GoB Spin, Market's Placidity

¶8. (U) The acceptance of "integral" pensions represents an abandonment of the GoB's original goal of early transition towards a unified social-security system with an eventual common ceiling for public- and private-sector pensions so as to curtail the grossly inequitable privileges enjoyed by Brazil's high-paid civil servants (Ref B). Defenders see it as a vital, if ugly, GoB compromise to gain legislative and Supreme Court approval of a pension reform that will bring Brazil at least the minimum fiscal benefits needed to keep the markets sunny. Grandfathering all current workers' benefits could save the final reform from judicial challenges based on loose interpretation of the Constitutional principle of "acquired rights" that cannot be withdrawn. Politically, the primary gain of the last fortnight's bargaining is that the governors seem warily back on board. In Congress, there is grumbling that the GoB walked back too much at the governors' behest, but no sign of major mutiny.

¶9. (U) Fiscally, the GoB claims its shift preserves the reform's "spinal cord" by improving the pension system's mid-to-long term financial viability. The GoB's prime assertion is that, thanks to the major increases in mimimum-age and length-of-work requirements, federal savings will not be meaningfully reduced by the extension of integral pensions. Under the original design, those savings were supposed to total 52.4 billion Reals through 2023. With the changes, they will be 50.7 billion. (Note: no methodology details available; these figures refer to federal civil servants only, excluding state and local public sectors, the military, firemen, and others. End Note.)

¶10. (U) For now, financial markets evidently take the GoB case at face value. Global-bank analyses we read all treat the revised pension-reform bill as being acceptable, as does the IMF, to judge from its indirect commentary. The recent uncertainties have had next to no effect on the exchange rate, while Brazil's country risk resumed its decline in July and is now at its lowest level since March 2002.

Fiscally Okay, but Politically Damaging?

¶11. (SBU) Fair enough, perhaps, in a green-eyeshade way. Yet the risk of collateral political damage to Lula seems high. There isn't even much assurance that the pension bill will

pass Congress in its new form. By ceding so much when the bill was at merely the second of seven legislative voting stages, the government may appear to have encouraged every interest group to stonewall for extra concessions. The GoB's intent to start taxing retirees' pensions is the most obvious likely target. Raising the survivor's-benefit ceiling is another. State and municipal judiciary employees demand that their salary sub-ceiling go back up to 90.25% of Supreme Court Justices', not the 75% demanded by the governors, and have declared they will strike August 5-12.

¶12. (SBU) More generally, the back-and-forth over pensions has let doubt be posed as to how clear, set and stable in its reform course the GoB really is. We believe such doubts are misplaced. But it is a fact that Lula's team has accepted a succession of major alterations to the design that it initially was adamant be taken as a whole. And their statements on pension issues - including Lula's own -- have often contradicted or reversed themselves. Hitherto, as a veteran interlocutor recently put it to us, most of Brazil's body politic seemed ready to board Lula's reform train, as long as he was driving it and taking the heat. Now, they can feel there is a political premium, and no penalty, in opposing his measures.

¶13. (U) Most immediately, this could affect Lula's tax-reform bill. Since the pension-bill's re-working, governors have been holding out for three compensatory alterations in the GoB's tax-reform bill: for states to share both the CPMF and CIDE taxes (each of which currently accrues 100% to the Union); for extra funds to compensate states for revenue losses stemming from the federal Kandir Law (which exempts exports from major taxes); and for lesser earmarking requirements on transfers from the federal treasury. If pension and tax reform bog down in a cycle of demands and concessions, Brazil's fiscal future and Lula's political stature will both be hard-hit.

Stiffened GoB Stance

¶14. (U) The GoB is well aware of these considerations. Lula, Berzoini and Dirceu as well as Palocci all are loudly warning that the government has reached the limit of its concessions vis-a-vis pension reform. In a personal meeting, Lula told the CUT (largest labor federation) leader that the GoB would introduce no further changes to its proposals. The administration responded to the state judges' strike threat with a refusal to entertain any negotiations, and Lula in a July 24 speech blasted their demands. And in its strongest show of renewed force, the administration on July 23 rammed the reform bill through the Chamber's special committee without further change by a 30-8 vote.

¶15. (U) The bill must now pass two Chamber floor votes, of which the first is expected in early August and the second probably not before September, with 60% majorities (Ref A). It would then go to the Senate's Justice Committee for a ruling on constitutionality and thence to the Senate floor for a further two votes, also requiring 60% majorities, the second of which is not generally expected before January. By all media accounts, Lula and Planalto are determined to take over direct management of the bills' legislative advance.

¶16. (SBU) Such signs of fresh resolve offer hope that Lula and team have absorbed lessons from the latest rough-and-tumble of the pension-reform process. Should they hold their re-configured line, the result will probably deserve to be deemed a success. But the prospect now looks more unsure.
HRINAK